

## **Ersättningar till Anställda**

### **Watson Wyatt's comments on Redovisningsrådet's draft recommendation of June 2001**

#### **Introduction**

- 1.1 This document sets out Watson Wyatt AB's comments on Redovisningsrådet's draft recommendation of June 2001 for a new accounting standard on employee benefits. The proposed new Swedish standard is essentially a translation of International Accounting Standard IAS 19.
- 1.2 Watson Wyatt is an international human resource, employee benefit and investment consultancy with more than 6000 employees in over 30 countries. In Sweden, Watson Wyatt AB offers the full range of our services. In particular, we have extensive experience on advising major Swedish companies and Swedish subsidiaries of foreign companies on the application of IAS 19 and similar standards, such as US FAS87 and UK SSAP24 and FRS 17. This includes making actuarial assessments of obligations. Our work in this area draws on the firm's extensive experience of applying these standards to a wide range of benefit plans in other countries.
- 1.3 We have closely tracked the proposed introduction of IAS 19 in Sweden. This included making representations to the IASC on the issue of whether a typical Swedish pension foundation could be regarded as a "plan asset" under IAS 19. The standard was changed in 2000, recognising the concerns expressed by a range of commentators in this respect.
- 1.4 The author of this document, Eric Steedman, by background a qualified UK actuary, is also a full member of the Svenska Aktuarieföreningen. One of Watson Wyatt's in-house experts on IAS19, he has worked with Swedish pensions, including the ITP plan, for over 4 years. For the last 2 years has headed our employee benefit consulting practice in Stockholm.

#### **Our approach**

- 1.5 Rather than considering the details of the Swedish translation of IAS 19, we have focussed our efforts on highlighting some areas that in our experience cause difficulty when applying this and similar standards in Sweden. As significant differences in view can arise, we believe that these are areas where it would be helpful if Redovisningsrådet could issue guidance to supplement the standard.
- 1.6 In doing so we have sought to highlight key issues of principle, rather than exploring every detail. In doing so have had regard to the original, English, wording of IAS 19. We would be happy to supplement these comments by discussions with Redovisningsrådet.

- 1.7 The areas which we have highlighted are:
- Treatment of ITP obligations which are secured by insurance (with Alecta)
  - Treatment of taxes associated with pension obligations (Avkastningskatt and Särskild Löneskatt)
  - Setting of the discount rate in Sweden
- 1.8 This document assumes the reader is familiar with the ITP pension system, accounting for its cost under existing Swedish GAAP, and the basic principles of IAS 19.
- 1.9 We consider each of these three areas below.

## A Insured ITP

1.10 Under the ITP plan, a company has three possible financing approaches for members pensions:

- Provisions on the balance sheet (FPG/PRI method)
- Backing by foundation (PRI backed by stiftelse)
- Purchase of insurance (normally from Alecta)

Spouse and family pensions under the ITP plan are always provided through insurance.

1.11 It is commonly accepted that for companies accounting under IAS19 (or similar standards such as FAS 87), an assessment of the obligations should be made in the first two cases. However, the case of insured ITP gives rise to a split of views.

1.12 In Bilaga 3 to its draft recommendation, under the heading “Klassificering av planer för ersättningar efter avslutat anställning”, Redovisningsrådet notes the importance of the categorisation of a post-employment benefit plan as “defined benefit” (DB) or “defined contribution” (DC). It notes various arguments, but finally concludes that ITP insured with Alecta should be categorised as a DC plan. As such, no IAS19 assessment of obligations would be needed- the plan would be accounted for on a cash flow basis.

1.13 We consider this conclusion to be flawed.

1.14 Experience under IAS 19 is limited but it is fair to acknowledge that most companies operating FAS 87 appear not to include insured ITP in any assessment. They simply account on a cash-flow basis for the premiums paid, with no provisions or prepayments arising. This appears to be a number of grounds, which depending on circumstances may include:

- When insurance is purchased, there is some risk and investment pooling with other employers. Some would argue that this makes the plan a "multi-employer" plan under which an assessment may not be needed under FAS87. The multi-employer element is rather small, and the problem of assessing ones share of the assets has become smaller following Alecta's attribution of surplus amongst participating companies
- The difficulty of obtaining appropriate information from Alecta to make calculations – in particular the share of the assets
- The historical existence within Alecta of a significant surplus which may outweigh any difference between a FAS87 liability assessment and the value of insurance purchased
- Materiality. Generally it is smaller companies who have insured all their ITP obligations, and larger companies using balance sheet or foundations insure only

a small part of their obligations, relating to disability and survivors pensions. So the insured part of ITP may often be regarded as immaterial.

- 1.15 All the above arguments may have a greater or lesser weight in the IAS19 situation, depending on circumstances. However, we have never heard it argued by our clients or their auditors that insured ITP should not be included in an IAS19 or FAS 87 assessment on grounds of being “defined contribution”.
- 1.16 We believe that there are two main grounds for not considering insured ITP to be “defined contribution”. We consider each in turn.

### *The requirements of IAS 19*

- 1.17 IAS 19 defines: “Defined Contribution plans are post–employment benefit plans under which an enterprise pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.”
- 1.18 All other post-employment benefit plans are categorised as “Defined Benefit”.
- 1.19 In Bilaga 3 to its draft recommendation, Redovisningsrådet paraphrases this definition, stating:

“En avgiftsbestämd plan kännetecknas av att företaget betalar fastställda avgifter och inte har någon förpliktelse av något slag att göra ytterligare betalningar avseende innevarande och tidigare perioder.”

- 1.20 Bilaga 3 then continues
- “Dessa villkor är uppfyllda beträffande pensionsplaner som försäkras i Alecta”.

- 1.21 We believe that this statement is not correct:
- Contributions to insured ITP are in no way “fixed”:
    - For any individual they will vary in future, often significantly, both as a SEK amount and a percentage of salary, according to a range of factors including that individual’s salary progression. Contributions are determined from an individual actuarial calculation which depends on future expected pension and contributions paid to date: they cannot be simply found in a look-up table.
    - Contributions may vary significantly following changes to Alecta’s calculation basis. For example they increased in May 1999 and now some reductions are proposed

- We do not see that by paying premiums to Alecta an enterprise necessarily discharges its obligations for current and prior periods. (On the understanding that in attribution of the obligation between prior and future periods it is the attribution under paragraph 67 of IAS 19 which is implied.)
  - The example below shows that some obligation for past service can remain even if insurance is purchased
  - In the event that Alecta's financing position deteriorated such that it could not pay out fully on insurance purchased from it, our understanding (based on conversations with Alecta) is that employers would remain under the obligation to meet ITP pension commitments for past service, to the extent Alecta did not do so.

1.22 In Bilaga 3 to its draft recommendation, Redovisningsrådet also states:

“Det kan också konstateras att en ITP-plan som försäkras i Alecta inte uppvisar det kännetecknet på en förmånsbestämd plan som anges i punkty 27, nämligen att företaget i allt väsentligt bär den aktuariella risken och investeringsrisken”.

1.23 We also disagree with this statement.

- Under insured ITP the employer continues to bear a range of substantial actuarial risks, including risk relating to future levels of salary increases, and risk relating to the proportion of members who leave employment before retirement. It is true that mortality risk is transferred to Alecta, but often on only part of the obligations as assessed under IAS 19 (see below re the difference between such obligations and the level of insurance which may be purchased from Alecta)
- The employer continues to bear investment risk, albeit not in such a direct form as if it used a foundation. If Alecta's investments do well, the employer has the prospect of benefiting from surplus. If the investments perform badly, then as outlined above our understanding is that the employer is in principle liable for future costs to make up any shortfall which arises.

1.24 Paragraph 41 of IAS 19 states :

“Where an enterprise funds a post-employment benefit obligation by contribution to an insurance policy under which the enterprise (either directly, indirectly through the plan, through the mechanism for setting future premiums or through a related third party relationship with the insurer) retains a legal or constructive obligation, the payment of premiums does not amount to a defined contribution arrangement. It follows that the enterprise:

- (a) recognises its rights under the insurance policy as an asset (if the policy is held by the enterprise itself) or as a plan asset (if the plan's rights under the policy meet the definition of plan assets); and
- (b) accounts for its obligations to the employees as a liability in the same way as if there were no insurance contract.”

- 1.25 We believe that in principle, this sets out how insured ITP should be accounted for. Liabilities should be assessed, and the corresponding assets with the insurance company offset from these.
- 1.26 Paragraphs 29 and 30 relating to multi-employer plans are also relevant. To a limited extent insured ITP has a multi-employer character, though the vast bulk of the benefits are paid for by each employer making individual actuarially-determined contributions for each employee. In substance therefore, we regard insured ITP as more in the nature of a “group administration plan”, with a small truly multi-employer overlay relating to certain risk benefits, and maximums on contributions for any individual. And this overlay is also present for companies using the PRI financing method, where it is commonly accepted that an IAS 19 assessment of obligations is required.
- 1.27 To expand on this, under ITP each employer promises benefits comprising an overall target less those benefits provided by previous employers in the ITP system. Once having promised those benefits, in substance it alone is responsible for paying for them. The extent of cost sharing with other employers is rather small. In the insured case employers also participate in a common insurance bonus pool. This is a common situation in other countries, and in itself would not normally be regarded as making a plan “multi-employer”. It merely is a factor which influences the likely proceeds of the investment policies purchased, and hence their value.
- 1.28 In paragraphs 29, IAS 19 essentially prescribes that as far as possible a multi-employer plan should be accounted for as if it were single employer.
- 1.29 We acknowledge that there may be practical difficulties in obtaining information from Alecta to make an assessment under IAS 19:
- Alecta is apparently unable to tell any employer how much of the ITP pension secured with Alecta has been purchased by that employer (as opposed to any previous employer)
  - Assessing the value of the deferred annuity insurance asset purchased from Alecta (in particular what value should be put on any future contingent right to benefit from surplus assets with Alecta) is not straightforward. However a large part of Alecta’s surplus assets were attributed to individual employers in 2000, which has eased this problem.
- 1.30 We believe the most natural treatment under IAS 19 is under paragraph 29, but *if* these difficulties are insurmountable (and we have not explored this fully with Alecta) then in some circumstances it may be reasonable to account for insured ITP under paragraph 30 of IAS 19. In other words, account “as if” the plan is defined contribution, but make additional disclosure relating to the nature of the plan and its financing, in particular relating to the prospects for future contributions.

### *Common sense and consistency*

- 1.31 Not including insured ITP in the IAS 19 assessment can in our view lead to results which are:
- At odds with a “common sense” view
  - Are not in line with the basic accounting concept of “prudence”
  - Are inconsistent between companies, and over time within a company
- 1.32 A simplified example will illustrate this.
- 1.33 Consider two identical companies with cash assets of SEK200,000 and using balance sheet provisions for their benefits. They each have two active employees at the same age and salary. Under IAS 19 the basic assessment of defined benefit liabilities is made as follows:
- An explicit projection of future pension payments is made. This includes explicit allowance for future inflation, salary growth, mortality, rates of disability and all other items which could affect the benefits.
  - These are discounted back to produce a total liability value at the current date. Let us say SEK100,000 for each employee.
  - This total liability value is split in direct proportion to the members’ service. So (simplifying slightly), for a member who joined at age 35, is currently age 50, and is assumed to retire at age 65, the past service liability is one half of the discounted value of total future benefits. This is known as the “Defined Benefit Obligation”(DBO), in this case SEK 50,000 for each employee.

1.34 On transition to IAS 19, the companies' balance sheets look like this:

	Company 1 kSEK		Company 2 kSEK	
Cash assets		200		200
IAS 19 DBO member 1	(50)		(50)	
Pension asset member 1	0		0	
IAS 19 DBO member 2	(50)		(50)	
Pension asset member 2	0		0	
Net pension obligation		(100)		(100)
Net asset value		100		100

1.35 Company 1 now moves to using Alecta to finance the pension obligations. This is a common occurrence. It buys insurance to cover the pension obligations which would have been purchased from Alecta had it always used the Alecta method.

1.36 If Alecta (or formerly SPP) had always been used, each year the company would have paid a premium to buy a slice of a deferred annuity insurance for each employee. The premium is set each year so as to purchase sufficient pension by 65 to pay the ITP benefit, *but allowing for no future salary increases above inflation*. The assessment of liabilities made by PRI for existing Swedish GAAP is essentially on the same basis: it is an accumulation of notional past insurance premiums. Such notional or actual premiums typically increase very rapidly later in an employees' career, as late career pay rises impact on the full career pension benefit and have to be funded out of premiums paid only in the last few years.

1.37 Assuming our two members have enjoyed salary increases above inflation, which is normal, it is quite normal that IAS 19 DBO will exceed the PRI liability, and so the insurance which may be purchased from Alecta, by a significant margin. (Anticipation of

future salary increases greater than inflation is one of the key differences between the IAS 19 and PRI liability assessment.)

1.38 So let us assume that for member 1, the company buys deferred annuities of value SEK 30,000 and SEK 40,000 for member 2. These being (essentially) the corresponding existing Swedish GAAP liability assessments made by PRI. The values can be different for members currently of the same age, service and salary, if their salary progression has differed in the past. (IAS 19 is more consistent than the PRI assessment in this respect: the liability assessment for two members of the same age, sex, earnings and past service is the same, unless there is any reason to assume they will have a different career profile in future.)

1.39 The balance sheet becomes:

	Company 1 kSEK		Company 2 kSEK	
Cash assets		130		200
IAS 19 DBO member 1	(50)		(50)	
Pension asset member 1	30		0	
IAS 19 DBO member 2	(50)		(50)	
Pension asset member 2	40		0	
Net pension obligation		(30)		(100)
Net asset value		100		100

1.40 The net asset value remains consistent between the companies, simply reflecting that Company 1 has bought SEK 70,000 worth of pension assets and reduced its cash by the same amount.

1.41 If on the other hand insured ITP is treated as a Defined Contribution plan, we would have:

		Company 1 kSEK		Company 2 kSEK
Cash assets		130		200
IAS 19 DBO member 1	Ignored		(50)	
Pension asset member 1	Ignored		0	
IAS 19 DBO member 2	Ignored		(50)	
Pension asset member 2	Ignored		0	
Net pension obligation		Taken as zero		(100)
Net asset value		130		100

1.42 By ignoring the pension obligations and assets in the balance sheet, we end up with a result which is not in line with common sense:

- Company 1 has paid SEK 70,000 to an outside party and somehow reduced its liabilities by SEK 100,000. In doing so it has apparently increased its net asset value by SEK 30,000. The implication is that some outside party will pay SEK 30,000 to the company.
- We sometimes hear it argued that Company 1 is “buying into” the Alecta surplus and will benefit from it in future. That may be so to some extent, but
  - In its past allocation of surplus, Alecta has taken account of the time for which it has held the funds of a company. Those who had used Alecta for a short period received little allocation- ie no immediate entitlement to surplus arises
  - it would be a remarkable coincidence if the value of any share of surplus the company is buying was exactly SEK30,000.

- 1.43 One could be sure that if such largesse by outsiders were really available, no Swedish company would use a balance sheet or foundation method to finance ITP: everyone would buy insurance for active employees, to benefit from this “free lunch”.
- 1.44 The fact that most larger companies do not use insurance shows that they recognise the reality is more complex. The SEK 30,000 cost will (if expectations are fulfilled) be charged to the company in future years by Alecta, by means of increasing levels of ITP premiums. On such a change of financing method (ie buying insurance), in our view it is prudent and consistent to continue to provision for these future increasing costs.
- 1.45 This simple example of a common situation shows that by treating insured ITP as a DC plan, we end up with results which violate the accounting principle of consistency: the results are inconsistent between companies, and over time within a company. In this particular example, releasing the SEK 30,000 provision also seems to violate the basic accounting principle of prudence.

## **B Treatment of taxes associated with pension obligations**

- 1.46 Two taxes are of importance to Swedish pension plans.
- Avkastningsskatt (at a rate of 15% of previous year's "Statslåneränta") is payable each year on assets in insurance contracts, pension foundations, and Swedish GAAP balance sheet provisions.
  - The other tax is Särskild Löneskatt. This special payroll tax of 24.26% arises on pension costs as described in Appendix A and is itself tax deductible.
- 1.47 IAS19 and FAS87 are silent on the treatment of these taxes (which is unsurprising as Avkastningsskatt appears to be unique to Sweden, and taxes such as Särskild Löneskatt are uncommon by worldwide standards).
- 1.48 Practice is not uniform, with some companies appearing to ignore future Avkastningsskatt and Särskild Löneskatt altogether in their IAS19 (or US GAAP) assessments. IAS 19 relates only to pensions, so it may be arguable that it does not relate to tax obligations arising from the commitment to pay pensions. However, to ignore such future tax obligations (to the extent they arise from past-service pension commitments) does not seem to us to be in line with the basic accounting concepts of prudence and consistency. Nor does it seem to us to be in line with the spirit of IAS 12. For example the Objective of IAS 12 states:
- “This Standard requires an enterprise to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves”
- and paragraph 15 of IAS 12 says:
- “A deferred tax liability should be recognised for all taxable temporary differences, unless.....”
- 1.49 Paragraph 26(a) of IAS 12 notes the deferred tax asset which may arise in relation to post-employment benefit plans: a company should take credit for tax deductions likely to arise in future, when pension payments or contributions are made in respect of benefit liabilities accrued but not yet funded. It seems inconsistent to recognise such an deferred tax asset, if similar deferred tax liabilities are not recognised.
- 1.50 Given different companies appear to be adopting different approaches in this respect, we believe it would be helpful for Redovisningsrådet to issue guidance as to the appropriate treatment of these two taxes. This would promote consistency between the accounts of different companies.
- 1.51 Below we describe how such taxes might be accounted for in relation to past service: similar considerations apply to the expense recognition each year in the P&L account.

### *Avkastningsskatt*

- 1.52 In principle, the most consistent approach would seem to be to make an explicit projection of future Avkastningsskatt payments relating to the pension commitments, calculate the discounted value of these, and then apportion between past and future accruals to calculate the DBO relating to them. This would then be added to the DBO calculated for the strict pension payments
- 1.53 The resulting total DBO would represent an assessment both of the future pension obligations and of the future Avkastningsskatt arising from the commitment to pay such obligations (to the extent those obligations are attributed to past service under IAS 19).
- 1.54 This is in line with the valuation of liabilities under current Swedish GAAP (the PRI skuld), which can be seen as a valuation of both future pension payments, and of future Avkastningsskatt arising from the commitment to make those future pension payments.
- 1.55 In practice, as a pragmatic approximation in line with the approach under Swedish GAAP, rather than make an explicit projection of tax obligations we have for some clients allowed for future Avkastningsskatt by reducing the IAS 19 or FAS 87 discount rate.

### *Särskild Löneskatt*

- 1.56 As for Avkastningsskatt, IAS19 is silent on the treatment of Särskild Löneskatt. Where the IAS19 liabilities exceed foundation funds, insured assets or Swedish GAAP provisions, we believe it would be consistent and prudent to include an additional balance sheet provision equal to 24.26% of the difference between the IAS 19 DBO and the base figure on which Särskild Löneskatt has already been paid or credited (ie the current Swedish GAAP provision, the value of funds in the foundations, or the insured assets.)
- 1.57 This would represent a provision for the tax cost on the future pension outgo attributed under IAS19 or FAS87 to past service, to the extent that such tax costs have not already been paid when building up Swedish GAAP balance sheet provisions, funding in a foundation, or through insurance purchase.
- 1.58 Such taxes are quite rare, but one country which has them is Norway. The approach described above is consistent with the approach taken in Norway to a similar tax under its accounting standard (very similar to FAS87).
- 1.59 This approach is also consistent with the inclusion in current Swedish GAAP balance sheets of a provision for future Särskild Löneskatt on direct pensions on which this tax is not paid until the time of actual benefit outgo (eg non-deductible pension provisions.)

## C Discount rate

- 1.60 Under IAS 19 discount rate is normally set as the yield on corporate bonds of duration matching that of the pension obligations. Where there is no “deep market” in corporate bonds, IAS19 specifies government bond yields should be used. (Paragraph 78)
- 1.61 It is arguable that there is no such “deep market” in corporate bonds in Sweden. Unfortunately the wording of IAS 19 is slightly unclear. On first sight it appears to indicate that in this case it is the actual yield on government bonds which should be used directly. However there is some scope to interpret the wording to say that the yield on government bonds should be used only *as a reference point*. It seems to be quite widespread practice to add a margin to government bond yields, to estimate the yields that would have been available on corporate bonds, had there been a deep market in them. This is certainly the practice under the US accounting standard FAS 87.
- 1.62 Paragraph 76 of IAS 19 also notes that where benefits are index-linked (which is the case for ITP and many other Swedish plans) and there is a “deep market” in index linked bonds, then the discount rate and other financial assumptions should be framed in real (inflation-adjusted) rather than nominal terms. The Swedish government issues index-linked bonds, but the market in them is rather illiquid.
- 1.63 We believe it would be helpful if Redovisningsrådet could issue guidance on:
- Whether it is considered that there is a “deep market” in SEK denominated corporate bonds
  - If not, whether the yield on government bonds should be used directly as the discount rate, or whether it is possible to interpret the standard to say that they are only a reference point, and so it is permissible to estimate the yields that would have been available on corporate bonds, had there been a deep market in them. This is not an issue unique to Sweden: in informal contacts with the IASC it has been indicated to us that this issue has not been considered by them in depth.
  - Whether the Swedish market in index-linked bonds is deemed sufficiently “deep” that assumptions framed in real terms are considered more reliable. We are not currently aware of companies explicitly using this approach.

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Stockholm, 8 November 2001

# A Särskild Löneskatt

Särskild Löneskatt, currently 24.26%, is levied on most pension costs. The special payroll tax is a responsibility of the employer and is itself tax deductible.

The tax is levied on:

- contributions to insurances covering occupational pension schemes (eg ITP insured with Alecta, alternative ITP).
- Allocations to pension foundations
- Increases in balance sheet provisions for pensions
- Directly paid pensions
- Reimbursement to other employers for transferred pension commitments.

Less

- Reimbursement from pension foundations
- Reductions in balance sheet provisions for pensions
- That part of the increase in balance sheet provisions deemed to be investment return/interest
- Reimbursement received from other employers for transferred pension commitments
- Negative amounts carried forward from previous year (if the tax basis currently shows a negative amount it can be carried forward and offset next year)